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Patrick K. Hogle; Salt Lake, Garfield and Western Railway Company, a Utah corporation; Ronald A. Johnson; J.W. Gallivan Children's Trust; H. Mack Brown; Jeff Owen; and Claire A. Singleton v. Zinetics Medical, Inc., a Utah corporation; Medtronic, Inc., a Minnesota corporation : Reply Brief

Utah Supreme Court

Original Brief Submitted to the Utah Supreme Court; digitized by the Howard W. Hunter Law Library, J. Reuben Clark Law School, Brigham Young University, Provo, Utah; machine-generated OCR, may contain errors.

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IN THE UTAH SUPREME COURT

PATRICK K. HOGLE; SALT LAKE, GARFIELD & WESTERN RAILWAY COMPANY, a Utah corporation; RONALD A. JOHNSON; J.W. GALLIVAN CHILDREN'S TRUST; H. MACK BROWN; JEFF OWEN; and CLAIRE A. SINGLETON, Plaintiffs, vs. ZINETICS MEDICAL, INC., a Utah corporation; MEDTRONIC, INC., a Minnesota corporation, Defendants.	Court File No. 980905416 CR Appellate Court No. 20000470 Subject to Assignment to the Court of Appeals
ZINETICS MEDICAL, INC., Petitioners, vs. AYYOOB ABBASZADEH; KENNETH ANDERSON; RICHARD BELLISTON, et al. Respondents,	

APPELLANTS' REPLY BRIEF

APPEAL FROM THE THIRD JUDICIAL COURT FOR SALT LAKE COUNTY, STATE OF UTAH
THE HONORABLE RONALD N. NEHRING, DISTRICT JUDGE

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TABLE OF CONTENTS

INTRODUCTION

In their opening brief the minority shareholders stressed two fundamental errors committed by the District Court. First, the District Court rejected all evidence of how the stock market would have valued Zinetics shares on the valuation data for reasons inconsistent with the governing statute and other applicable state law. Certainly, the District Court is invested in this equitable proceeding to consider the weight, if any, to be given to the evidence but those decisions must be consistent with applicable law. The valuation data applicable to this decision was February 12, 1998, during the most robust stock market of the last twenty years. The Court's rejection of all market-based evidence deprived the minority shareholders of the value of their shares in such a market. The Court's conclusion that market based values would "fluctuate inexplicably over time in a manner unrelated to the fundamental financial performance of the companies," even if it had been supported by the record, which it had not, is irrelevant.

In a free market, financial ratios of groups of companies do vary widely over time. If this were not true, markets would be largely static and there would be no need to perform data specific analysis. Critically, the controlling statute Utah Code. Ann. § 16-10a-1301(u) requires synchronic analysis. In light of the statutory requirements, the Court erred in rejecting the market analysis proffered by the minority shareholders.

The District Court's other reason for rejecting market valuation methodology is that the methodology "has not been recognized as a valuation tool by our courts." That conclusion is simply wrong.

Finally, Medtronic's attempt to bootstrap an evidentiary basis for the Court's conclusion that the fair value of the shares was less than that imposed on the minority shareholders in the freeze-out merger cannot withstand scrutiny. As demonstrated below and in the minority shareholders' opening brief, the Court failed to adequately support its conclusion that the minority shareholders received the fair value of their shares.

I. THE MINORITY SHAREHOLDERS DID NOT RECEIVE FAIR VALUE FOR THEIR STOCK BECAUSE OF THE REFUSAL OF THE DISTRICT COURT REFUSED TO CONSIDER ANY STOCK MARKET VALUATION INFORMATION

The minority shareholders in this proceeding own shares of stock in Zinetics. The minority shareholders did not own an apartment building, an annuity, or the right to receive income. They owned freely trading shares of stock for which many had paid between ten and seventeen cents per share. See Appellants' Br. at 4. They had the right to receive fair value for their stock and to have that value determined the way value for shares of stock is typically determined -- by examining market data. The sum total of all available market information is what the Court below should have used to determine the value of the minority shareholders' investment in these shares. However, the District Court failed to consider any relevant market information.

The parties provided the District Court with a great deal of evidence as to how the market valued shares of other similar companies on or about the valuation date. That testimony came from Mr. Reilly, the shareholders themselves, and Mr. Norman. All of this information led ineluctably to the conclusion that the shares had a higher fair value than that imposed by Medtronic in its freeze-out merger.

The minority shareholders presented evidence of market valuation of the Zinetic stock that was offered by a respected expert, Robert Reilly. The methodology was consistent with long accepted valuation techniques and described by Mr. Reilly in his book Valuing a Business: The Analysis and Approval of Closely Held Companies.

In the period prior to the merger, shares of Zinetics had traded between 10 and 17 cents per share. Mr. Reilly and Mr. Norman did not use that information in calculating a value, because of the thinness of the market for Zinetics' stock. Nonetheless, that hardly means that the District Court should totally disregard such information, particularly when the information is not inconsistent with other market data.

As is nearly always the case, there was no company that was so nearly identical to Zinetics that it could be used as a "comparable," as that term is typically used in real estate valuation. Instead, Mr. Reilly identified an array of companies that were the most similar to Zinetics and that also were publically reporting companies so that adequate information could be obtained to calculate the fair value of Zinetics shares. Such companies are typically referred to by valuation experts, such as Mr. Reilly, as "guideline companies."

A. The Guideline Companies Were Not Dissimilar to Zinetics

Medtronic suggests that the companies selected by Mr. Reilly as guideline companies were dissimilar to Zinetics. See Appellees' Br. at 22. That is demonstrably false. Mr. Reilly, in his testimony, enumerated the factors that he used to select guideline companies. First, he started by selecting companies with SIC Code 3841. SIC 3841 is the standard industry code for companies that manufacture medical products. Then he used a size similarity factor, selecting companies by imposing the requirement that the companies be within an order of magnitude of Zinetics in sales, which is to say that they were neither ten times smaller nor ten times larger than

Zinetics. Third, the companies had to be domestic companies with actively traded stock and should be traded either OTC or on NASDAQ. Fourth, the companies had to have material revenues which means that they were actually producing and selling products. In fact, the guideline companies selected by Mr. Reilly were growing at about the same pace as Zinetics. The companies were past the development stage because they had successfully commercialized some of their products, and, finally, they all produced catheters. See Tr. at 503-10.

Mr. Reilly then applied all these criteria, which Mr. Norman admitted were proper (Tr. 733), to a data base of over 11,000 companies, and used all of the companies that met them. That selection process produced 11 companies. He used the median of that array of companies as the best measure of central tendency.

The District Court, in its opinion, rejected the market information this methodology produced, saying that Mr. Reilly made no adjustment for "structural and performance differences." See Mem. Dec. at 13. With respect to "structural" issues, there was no evidence that there is anything structurally dissimilar in comparing the guideline companies to Zinetics. They all manufacture catheters, they are all of approximately the same size, they are all in production and producing revenues, and there was no testimony that any of them had unusual capital structures that would have somehow made them "structurally" different.

With respect to performance differences, the only difference argued by Medtronic was that Zinetics was more successful than the other companies because it had higher earnings, even though similar revenues. Generally speaking, companies that are more profitable are worth more on the stock market, not less. Thus, the District Court and

Medtronic appear to be criticizing the use of the guideline companies on the grounds that the pricing information available by reference to these guideline companies was not adjusted upward by Mr. Reilly. Had Mr. Reilly made adjustments in the way the market itself values these companies, he would increase by adjustment the value of Zinetics.

As explained above, Mr. Reilly selected his guideline companies by applying neutral criteria to a database of over 11,000 companies to select those that most closely mirror Zinetics. Thus, Medtronic's suggestion that those guideline companies are dissimilar to Zinetics is simply not true.

B. There Was No Expert Testimony Offered Supporting The Conclusion That "Adjustments" Should Be Made To A Valuation Methodology Using Guideline Companies

Medtronic provided no testimony that adjustments should be made to valuations derived from guideline company methodology that Mr. Reilly employed. Had Mr. Reilly made such adjustments, he would not be using information directly from the market but making adjustments to it and thus imposing his own subjective opinion on the objective process. One can safely assume that had Mr. Reilly adjusted the price upward to account for the comparative profitability of Zinetics to the other small, catheter-producing companies, Medtronic would have criticized him for doing so and, likewise, would have urged the Court to reject such information on the grounds that Mr. Reilly improperly adjusted market information. In fact, there was no "adjustment" proposed to the market-derived valuation of Mr. Reilly. Rather, the District Court was simply urged to reject it entirely.

There is an obvious reason for this, and one only need look at Mr. Norman's own testimony to understand Medtronic's motivation. Mr. Norman also purported to value

Zinetics based upon market information. However, instead of applying neutral criteria to the entire database of companies, Mr. Norman selected huge, multi-national medical companies as his guideline companies. Mr. Norman then derived price earnings ratios from these companies. He testified that using price earning ratios is a much better way of valuing companies than a market capitalization to revenue ratio. Having obtained those price earnings ratios, Mr. Norman was then forced to adjust them by nearly half in order to bring his valuation within that imposed by Medtronic in the freeze-out merger.

Interestingly, however, Mr. Reilly testified that smaller companies tend to have larger PE ratios than bigger companies. See Tr. at 573. Mr. Norman did not counter this testimony at all. Thus, Mr. Norman apparently made an adjustment that is directly inverse to how the market actually works. If Mr. Norman had only used the price earnings ratios that he had determined and applied it to the earnings of Zinetics, a valuation of approximately $ .09/share would result.[1] This would undervalue Zinetics because of size disparity.

As the testimony also demonstrated, Zinetics was consolidated for financial purposes with Medtronic. Medtronic traded at more than 50 to 1 price-to-earnings ratio. See Appellants' Br. at 18. Thus, the market valued each dollar of earnings of Zinetics prior to and subsequent to the freeze-out merger at an approximately 50-1 price/earnings ratio, to the benefit of Medtronic's shareholders. In this equitable proceeding, the District Court should have concluded that this evidence has at least some probative value.

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1 The P/E from Schedule M is 24. Multiply trading earnings of $480,500.00 and divide by number of shares (128,806,800 shares) = 9 cents/share.

Medtronic argues that the District Court had unfettered discretion to accept or reject evidence. The Court's discretion is not unlimited. The Court must exercise that discretion consistent with the governing statute. The District Court's rejection of market information by imposing a requirement that financial ratios be consistent over time -- which they never are -- is legal error and requires reversal.

In sum, all of the information available as to how shares of companies similar to Zinetics actually trade in the market, as well as the information as to the actual trades in Zinetics, create values for Zinetics of 9 to 25 cents per share. The minority shareholders were entitled to get the fair value of their shares of stock, not the value of something else. For the District Court to reject all information that shows what Zinetics shares actually sold for and what similar shares sell for in the market deprived the minority shareholders of the "fair value" of their shares to which they were statutorily entitled.

In conclusion, whatever discretion the District Court had, it did not have the discretion to reject Mr. Reilly's testimony on grounds inconsistent with the controlling statute, inconsistent with other applicable law and inconsistent with acceptable methodology. As a direct result of the District Court's rejection of the market method, the minority shareholders were deprived of receiving the fair value of their stock on a date during the most robust stock market in history.

II. NO SUBSTANTIAL EVIDENCE SUPPORTS THE COURT'S CONCLUSION OF FAIR VALUE

This equitable proceeding before the Court was to determine the fair value of the Zinetics shares on February 12, 1998. The Court rejected or ignored all evidence of value other than an income or discounted cash flow methodology, which the Court denominated "investment valuation." The Court's ultimate conclusion, stated on page 13 of the Opinion, was:

> When the numbers proposed by Respondents for revenue discount rate and capitalization rate are used to recalculate Mr. Norman's investment valuations, the results do not exceed the $0.04528 per share offered by Medtronic for the Respondents' common stock.

Opinion, p. 13. One of the predominant issues in this appeal is whether any substantial evidence supports that ultimate conclusion.

An examination of the calculation the Court indicated should be used reveals that the minority shareholders did not receive fair value for their shares. An income or discounted cash flow valuation is the sum of yearly calculations which are relatively simple once the numbers to be used are derived. One need only take the projected revenues and divide by the capitalization rate to determine the yearly valuations which are then summed to result in a total valuation. The revenue projections are simply an initial year's projection increased by a set rate.

The numbers "proposed by Respondents" for each of the revenue discount rate and the capitalization rate may be found in Mr. Reilly's report. See Exs. VIII through XI. With respect to the first year's projected revenues, Mr. Reilly criticized Mr. Norman's calculations because Mr. Norman viewed a company which had shown incoming increasing revenues at a compound rate of approximately 23.1% for a period of five years and without explanation projected earnings for the first or base year that were less than the prior year. In other words, Mr. Norman took Zinetic's steadily increasing earning stream and decreased it without any reasonable explanation. Mr. Reilly did not "propose" that the base year be set at the same level as the preceding year. Instead, Mr. Reilly followed the trend of Zinetics' earnings and projected a base year higher than the preceding year.

If the numbers for revenue capitalization rate and inflation rate "proposed by Respondents" are used, and all other valuation information, including the market approach and the minority shareholders' offer to purchase are ignored, then the value of the shares may be obtained by simply calculating the given amounts. As set forth on page 2 of Ex. XI to Mr. Reilly's report, the average of those three iterations is $17,283,000. If one divides that number by the number of outstanding shares (128,806,800) of Zinetics, then one obtains a valuation of $0.1342 per share. That value is substantially more than the approximately 4 cents per share the minority shareholders received from Medtronic.

Mr. Norman's calculations, adjusted to use Respondents' proposed numbers, as the Court stated was appropriate, is the only basis of supporting the Court's conclusion. Nothing else in the record supports that conclusion. If the District Court's opinion is to be made internally consistent, and the numbers "proposed by Respondents for revenue capitalization rate and inflation rate" are used, then the result is that the minority shareholders should be paid $0.13 per share. Thus, even if every other point raised on appeal by the minority shareholders is rejected by this Court, in order to make the Court's opinion internally consistent and adopt the methodology the Court apparently believed it was using, the judgment should be reversed and the minority shareholders should be entitled to be paid the difference between $0.04528 and $0.13 per share.

Medtronic attempts to provide the calculations the District Court did not set out in its opinion. See Appellees' Br. at 15-16. However, the calculations they provide are inconsistent with the District Court's opinion. Mr. Reilly did not "propose" to add a 10% increase to Mr. Norman's projections. Rather, he noted that one effect of Mr. Norman's diminishing earnings from previous years was to lock in a 10% reduction. The calculations that Medtronic offers appear no where in the record, and neither the minority shareholders nor Mr. Reilly proposed such calculations. They are simply an attempt to provide support for the District Court's conclusion when none exists in the record.

An entire calculation on a year by year basis, including both increases and discounting, would be necessary in order to provide the true numbers that Mr. Reilly proposed on behalf of the minority shareholders. Fortunately, those numbers appear in Mr. Reilly's report and the results are as indicated above.

Medtronic purports to cite support in the record for the conclusions of the District Court. See Appellees' Br. at Add. 4. The most important of these is the purported support on page 13 for the District Court's statement that "when the numbers proposed by Medtronic for revenue, discount rate and capitalization rate are used to recalculation [sic] Mr. Norman's investment evaluations, the results do not exceed the 0.04528 per share offered by Medtronic for the Respondents' stock." As evidence, Medtronic cites to Norman testimony at trial, pp. 731-32 and Norman Report Schedules A, F., G. I, and J. These references do not support the court's opinion. One will not find the numbers that Medtronic proposes for either revenue discount rate or capitalization rate in Mr. Norman's testimony or in his report schedules.

For instance, Schedules A, F, G, I and J are the original schedules Mr. Norman offers as part of his valuation report. They are his calculations -- not projections Mr. Reilly offers. The testimony at 731-32 is simply a statement in response to one criticism. Mr. Reilly had criticized Schedule F -- a direct capitalization model -- by pointing out that Mr. Norman had built in a 10% persistent decrease in earnings into perpetuity. Mr. Reilly neither adopted Mr. Norman's projections nor "proposed" that if Norman's projections could be corrected by only adding 10% to the base year. Mr. Reilly only offered this criticism of Mr. Norman's direct capitalization model as an example of its fundamental deficiencies.

In short, the Court's conclusion that the fair value of the minority shareholders' Zinetics shares was less than the $0.045 per share that they received from Medtronic finds no support in the record. Medtronic's valiant attempt to prop up the District Court's decision falls far short of the mark. This Court should remand this case for an adequate determination of the fair value of the dissenters' shares.

III. THE DISTRICT COURT MADE NO FINDING THAT THE MINORITY SHAREHOLDER'S ATTEMPT TO PURCHASE THE MAJORITY OF THE SHARES FOR $.10 PER SHARE WAS A "SHAM"

Perhaps the low point in Medtronic's brief is their gratuitous characterizations of the minority shareholders' final offer to purchase the majority block of shares of Zinetics as "bogus" and a "sham." See Appellees' Br. at 30-31. The District Court made no such finding. Rather, the District Court totally ignored this evidence completely. As the record indicated, the minority shareholders had resources available to make such an offer. See generally Testimony of Jack Gallivan and Ronald Johnson. Moreover, such a price was not inconsistent with prices paid many years earlier by these shareholders.

See generally Testimony of P. Hogle and J. Gallivan. For Medtronic to accuse the Gallivans, Hogles and others of engaging in a sham with no such finding by the District Court is shameful.

CONCLUSION

Because of the District Court's errors, the minority shareholders were deprived of recovery of the fair value of their shares. They were forced to surrender those shares to defendants in a freeze-out merger and as a result they should be entitled to fair value. The best measure of the value is ascertained by determining the financial ratios at which similar guideline companies sold in efficient stock markets on the valuation date. The District Court rejected that information for reasons inconsistent with the governing statute.

The minority shareholders respectfully submit that this Court should reverse the District Court's decision and either determine a proper valuation based upon market data or remand to the District Court with instructions to either appoint a special master or include the guideline company valuation data in its final determination of fair value.

DATED this 28th day of September, 2001.

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CERTIFICATE OF SERVICE

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